Blogs
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Distribution in Guise Settlement Orders Reinforce Need for Better Compliance, Contracting, and Disclosure Practices (Part 2)

This post continues our discussion of the settlement orders that the SEC recently entered into with investment advisory firms based in Chicago (the "First Order") and Maryland (the "Second Order"). These cases illustrate that the SEC remains focused on mutual fund distribution issues and teach some hard lessons about the importance of compliance oversight, contracting, and disclosure around distribution and sub-transfer agency ("sub-TA") payments. The improper payments detailed in the First Order were discovered by the firm during an internal review conducted after it knew that the SEC's Office of Compliance Inspections and Examinations ("OCIE") would be examining its intermediary payments. According to the First Order, "After identifying the payment errors, [the adviser] promptly notified the Board, reimbursed the Funds with interest, and supplemented its practices of providing oversight of payments to financial intermediaries." But these two recent distribution in guise enforcement cases, together with the first one brought in connection with OCIE's sweep exam that was settled in 2015, show that liability may be present even where mitigating factors exist, such as a firm and fund board undertaking due diligence and reviewing and/or remediating misclassified payments. Moreover, while press reports suggest that the First Order and the Second Order may represent the end of enforcement follow-up from the distribution in guise sweep exam, distribution and intermediary payments continue to be an OCIE priority. An ounce of prevention is worth a pound of cure when it comes to mutual fund distribution payments, and the following are some observations that can be drawn from the Orders for best practices going forward.

Compliance and Contracting Practices

As we have commented before, offense is often the best defense. Carefully drafted agreements that clarify the services to be provided by and the sources of compensation to be paid to intermediaries are a key element to avoiding payment for distribution outside of a Rule 12b-1 plan. Care should be taken to negotiate with each intermediary contractual provisions that specify which services are primary intended to result in the sale of fund shares (distribution services), which fees will be used to pay for distribution services, and which fees will be paid for sub-TA services, if any. Separate and auditable contracts and payment streams are likely to avoid the type of misclassification that plagued the Chicago firm in the First Order. But as both Orders underscore, even when contractual language is relatively clear (regarding, for example the source of revenue share payments due to an intermediary), failure to abide by contractual terms may put a firm in violation of Section 12(b) of the Investment Company Act of 1940 (the "1940 Act"). Advisers and fund boards should act now, if they have not already, to assess their financial intermediary arrangements in light of the recent Orders and the SEC's 2016 Distribution in Guise IM Guidance Update. Such an assessment should, among other things: take into account all factors identified in the Guidance and the Orders; seek to identify any sub-TA fee payments made above board-approved and disclosed limits; scrutinize any outlying payments by the adviser to intermediaries; focus on identifying any discrepancies between fund disclosures and sub-TA fee payment practices; provide for the refunding of any improper payments to affected funds; and require the development and implementation of control procedures and enhancements to correct any identified shortcomings.

Fund Disclosures

In both Orders, liability for the actual violations was compounded by the low-hanging fruit of inaccurate disclosure. The good news is that the disclosure in question appeared fairly broad and in line with industry standards, and no findings were made with respect to its inclusiveness or the actual fee levels (which in the case of the Maryland firm were relatively high). Instead, the Orders focus on specific inaccuracies, emphasizing the importance of establishing controls to ensure that limits set in disclosure are carefully adhered to.

Nature of Payments

The Orders do not shed light on whether certain services may or may not be "primarily intended to result in the sale of shares" within the meaning of Rule 12b-1 under the 1940 Act. Liability is far more likely to result where there has been a clear misapplication of payments. Of note, agreements in both Orders suggest some "bundling" of revenue share payments in a single contract with Rule 12b-1 and sub-TA payments. Also, consistent with the Guidance, the Orders do not identify issues with common arrangements whereby funds pay sub-TA fees to their advisers as reimbursement for fees paid to intermediaries for bona fide non-distribution services and pay different rates, under different agreements, for different levels of sub-TA services provided to different types of funds distributed in different distribution channels. The Orders also did not challenge the use of a firm's own assets to pay for distribution services (i.e., revenue sharing).

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